The Manufacturers Hanover
Financial Digest
Economic Commentary, Selected Financial Data, and Business Indicators

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GNP Growth In 1986 Will Be Aided . . .

The Bureau of Labor Statistics' latest employment numbers provide a first glance at this year's economic prospects and, coming on the heels of several upbeat business statistics during the final months of last year, tend to confirm that the economy entered 1986 on a strong note. The number of people employed reached a record 109 million last month, while the number of people without jobs fell below the eight million mark for the first time since 1981. As a result, the unemployment rate retreated to 6.7 percent—the lowest rate in almost six years. While the service sector once again accounted for the bulk of the employment gain, it is encouraging that manufacturing employment increased for the fourth consecutive month, a trend which has reversed some 60 percent of the substantial decline in factory jobs which occurred between January and September of 1985.

Although the upturn in manufacturing employment is welcome in itself, even better news may be on the way. This is because the manufacturing sector should continue to improve throughout 1986 not only because of the weaker dollar in the foreign exchange markets but, perhaps equally important, because of the need to replenish inventories. The drag on growth stemming from both diminished inventory spending and a widening trade deficit may be about to end. Although December's monthly trade deficit surged to a record level, faster growth in Europe and the recent slide in the dollar—touching a seven-year low against the yen alone this week—suggest that the U.S. net export position should post a gradual improvement over the course of 1986. So, too, the contribution from inventory building is expected to increase.

. . . By Greater Inventory Accumulation . . .

The volatility in inventory spending and its effects on output can be seen in the economic growth rates posted over the past two years. Although inflation-adjusted GNP grew only 2.5 percent in 1985, substantially below the 6.6 percent rate of advance in 1984, the rate of growth in real final sales in both years did not differ substantially. Real final sales increased by four percent last year, compared with a 4.5 percent rise in 1984. The divergence in output in these years stemmed primarily from different postures toward inventory accumulation adopted by business.

Early in 1984, there was a feeling in the business community that inventories had gotten too low relative to current and projected sales. In addition, many businesses believed that the rate of inflation would accelerate as it typically does at this stage of the business cycle. That belief provided an incentive to stock up on goods since inflation would be increasing the value of goods on hand, thus boosting profitability. Furthermore, business plans for investment in plant and equipment were also strong, sending a signal to a wide variety of industries to gear up for the increased demands. As a result, inventory accumulation of almost $63 billion took place in 1984, contributing 2.1 percentage points to the real GNP growth rate.

On the other hand, this situation reversed itself last year. For one thing, retailers were shell-shocked from their experience during the 1984 holiday shopping season. They stocked up heavily in anticipation of strong holiday buying. Sales, however, fell short of expectations and retailers were caught with large amounts of unsold goods. They had to resort to substantial markdowns early in the holiday season to clear out surplus merchandise. For another, the low rate of inflation posted in 1984 combined with high real interest rates removed the incentive to stock up on merchandise. Businesses turned cautious, determined to keep their stocks as lean as possible. While this led to more efficient inventory management in 1985, the reduction in the rate of inventory accumulation restrained the growth in output.

The $7.3 billion increase in inflation-adjusted business inventories in 1985 marked a significant slowdown from the $62.6 billion accumulation pace of 1984. This deceleration depressed real GNP by more than $55 billion, subtracting 1.6 percentage points from last year's growth. If inventory spending last year had done no more than match the preceding year's rate, real GNP would have increased by 3.9 percent in 1985.

. . . As Industries Restock Their Shelves

It now seems that inventory building has slowed to the point where some snapback appears in the

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offing. The recently released monthly statistics on the manufacturing sector's inventories and shipments indicate that factory managers have not yet begun restocking their shelves. Inventories fell in December for the sixth straight month while shipments rose slightly. Out of the 14 major industries reporting, ten had inventories below the December 1984 levels. The biggest drop was in primary metals where inventories fell 14 percent over the year and were at their lowest point since April 1978. On the other hand, stock rebuilding was at its strongest in the transportation equipment sector.

For all manufacturing, the rise in shipments coupled with the drop in inventories pushed the inventory-sales ratio, which indicates how many months existing inventory would last if its was the only source for shipments, to its lowest level in two years. For individual industries, however, other factors—expected future prices of inputs, carrying costs and a product's shelf life—influence the optimum ratio of inventories to sales. In the food processing industry, for example, the short storage time of food dictates that inventories be kept consistently below the level of shipments. Even during the two recent recessions, the inventory-sales ratio never topped one month.

Another industry currently with a low ratio is the coal and petroleum sector. At .44, this industry had the lowest ratio of the industries reporting in December—an understandable development in light

Selected Federal Reserve Data

	Week Ending 2/12/86		
Reserve Bank Credit			
U.S. Gov't's and Agencies			
Owned Outright & RPs	180,484	— 5,666	+15,136
Loans to Depository Inst.	596	— 131	— 499
Float	1,179	— 301	+ 455
Total Reserve Bank Credit	198,105	— 5,970	+18,555
Treasury Deposits with Federal Reserve Banks	6,854	— 5,621	+ 2,057
Currency in Circulation	181,293	+ 668	+12,814
Gov't's held for Foreign Acct. by F.R. Banks (End-of-Week)	128,231	— 177	+12,005
	2/12/86		
Member Bank Reserves:			
Total Reserves Held	45,402	+ 194	+ 5,236
Excess (Deficiency)	1,186	+ 259	+ 174
Net Free Reserves	1,004	+ 451	+ 373
Monetary Aggregates †			
M1 (2/3/86)	624.6	+ 10.1‡	+ 11.2‡
M2 (January '86)	2,567.1	+ 4.6	+ 7.0
M3 (January '86)	3,211.6	+ 6.1	+ 6.6
Domestic Nonfinancial Debt (3rd Q'85)	6,523.1	+ 11.7	+ 13.7

†Seasonally adjusted. * Seasonally adjusted annual rate. ‡ Four-week moving average.

New York Money Market

	3 Month	6 Months	1 Year
Offering Rates 2/14/86			
‡U.S. Treasury Bills	6.99%	7.08%	7.08%
* Federal Agencies	7.49	7.63	7.77
* Municipal Notes—High Grade (46% Taxable Equivalent)	9.07	9.44	9.44
Negotiable Time CDs:			
Manufacturers Hanover	Rates By Arrangement		
* Secondary Market—Prime	7.67	7.70	7.75

‡Finance Company Paper—Prime		‡* Bankers' Acceptances	
5- 14 days	7.65%	Mar.	7.65%
15- 29 days	7.70	Apr.	7.60
30- 59 days	7.70	May	7.50
60- 89 days	7.75	Jun.	7.45
90-179 days	7.65	Jul.	7.43
180-239 days	7.55	Aug.	7.38
240-270 days	7.45		

‡Industrial Paper—Prime			
30- 89 days	7.75%	†Federal Funds	
90-120 days	7.65	Effective Rate	7.69%

‡Discount basis. * Subject to availability. † Estimated.

Selected Business Indicators

Gross National Product (Current Dollars)*	4th Q'85	$ 4,075	$ 4,017	$ 3,853
Gross National Product (1982 Dollars)*	4th Q'85	$ 3,605	$ 3,564	$ 3,516
Percent Change, Annual Rate	4th Q'85	2.4	3.0	0.6
Change in Consumer Prices*	Dec. '85	4.0%	7.2%	3.6%
Change in Producer Prices*	Jan. '86	0.4	6.0%r	— 1.2%r
Civilian Employment (Thousands of Persons)†	Jan. '86	108,969	108,206	106,315
Unemployment as % of Civilian Labor Force†	Jan. '86	6.7%	6.9%	7.4%
Personal Income*	Dec. '85	$ 3,394	$ 3,347	$ 3,207
Leading Indicators Composite Index (1967=100)†	Dec. '85	173.6	172.0	164.1
Industrial Production Index (1977=100) †	Dec. '85	126.7	126.3r	123.6
Net Change in Consumer Installment Credit †	Dec. '85	$ 7.13	$ 4.79r	$ 6.82
U.S. Merchandise Trade Balance †	Dec. '85	$ 17.32	—$ 13.68	—$ 8.03
Plant and Equipment Expenditures*	1st Q'86	$402.43(a)	$388.98(a)	$371.16
Private Housing Starts (Thousands of Units)*	Dec. '85	1,840	1,566	1,630
New Construction Expenditures*	Dec. '85	$ 354.6	$ 344.8r	$ 310.1
Total Business Inventories †	Dec. '85	$ 582.2	$ 582.8r	$ 573.4
Total Business Sales †	Dec. '85	$ 436.2	$ 432.0r	$ 421.6

*Seasonally adjusted annual rate. †Seasonally adjusted. (a) Newly reported figure. r Revised. a Anticipated.

of the price cuts that were taking place in the oil industry. Although shipments slowed, inventories deteriorated more sharply as firms shipped out more expensive crude in anticipation of replenishing stocks with cheaper, incoming oil.

Automakers also pushed inventories below the current monthly sales rate. Inventory reductions did begin last summer in the auto industry, but the jump in demand during the August and September financing incentives cut into inventories and pushed down the inventory-sales ratio although it remains high by Detroit's standards.

With inventories becoming a smaller source of available goods, production and employment will begun to turn around. After falling in eight of the first nine months of 1985, factory production employment has regained 164,000 jobs in the last four months. And the index of manufacturing production rose 1½ percent in November and December 1985. Unfortunately, while in the aggregate a move to replenish inventories will result in an increase in employment, the same is not true on an industry by industry basis since other factors influence labor decisions. For example, the chemical industry has increased inventories 11 percent since their recent trough in 1983, but improved production efficiency has boosted output thus eliminating many jobs.

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The first issue will be dated March 3.

Short Term Paper Outstanding

		Change Since	
	Week	Week Ago	Year Ago
Time Deposits of $100,000 or more Weekly Reporting Banks			
Nationwide (1/29/86)	183,430	+ 627	+ 7,489
New York City (2/5/86)	39,865	+ 191	+ 3,562
Commercial Paper (2/5/86)	290,016	– 2,909	+81,395

Bank Loans

Commercial and Industrial Loans

		Change Since	
Weekly Reporting Large Commercial Banks	Week	Week Ago	Year Ago
Nationwide (1/29/86)	754,687	– 1,841	+ 3,999
New York City (2/5/86)	57,624	– 115	– 3,731

Total Loans and Leases Gross Adjusted

		Change Since	
	Week	Week Ago	Year Ago
Nationwide (1/29/86)	717,134	– 3,359	+ 62,985
New York City (2/5/86)	155,631	+ 612	+ 14,141

Financial Markets

	Friday 2/14/86	Week	Year Ago
U.S. Governments, Closing Yields:			
90-Day Bills†	7.29%	.21	– 7.22
180-Day Bills†	7.40	.17	– 1.25
Longest Bills†	7.80	.18	– 1.50
Recent Issues:			
8¼s 1/31/88	8.30	.18	
8⅜s 12/31/89	8.17	.13	
8⅞s 2/15/96	8.66	.43	
9¼s 2/15/16	8.40	.38	
Municipals:			
Bond Buyer–20 Bond Index* (2/13/86)	7.52%	.11	2.02
Blue List Total ($ Million)	$3,375	+ $ 63	– $ 422
30-Day Visible Supply ($ Million)	$ 860	+ $147	$2,158
Total	$2,055	+ $210	$2,579
Corporates:			
Moody's Aa Composite (2/13/86)	10.00%	.05	2.13
30-Day Visible Supply ($ Million)	$1,050	+ $125	+ $ 55
Stocks:			
Dow-Jones Averages:			
Industrials	1,063.45	+ 51.05	+ 382.43
Transportation	472.97	+ 10.56	+ 143.70
Utilities	180.08	+ 3.90	+ 29.80
65 Stocks	862.80	+ 16.45	+ 138.35
N.Y.S.E. Composite Index	126.02	+ 2.94	+ 21.38
N.Y.S.E. Avg. Daily Vol. for Week (000's)	140,710	9,048	+ 19,234

* 46% Taxable equivalent 14.11%

† Bond equivalent

International Rates

EURODOLLAR DEPOSIT RATES (bid)	Friday 2/14/86	Week Ago
Overnight	7.69%	7.69%
1 month	7.88	7.88
3 month	7.38	8.00
6 month	7.94	8.00
1 year	8.06	8.25
EURODOLLAR BONDS		
Average Yield		
Medium Term (5 to 7 yrs.)	8.80	9.00%
Long Term (7 to 15 yrs.)	9.35	9.50

FOREIGN EXCHANGE SPOT RATES

New York Opening (2/14/86)	U.S. $ Equivalent	Currency Per U.S. $
Belgium	.02074	48.21
Canada	.7171	1.3945
Denmark	.1153	8.6750
France	.1381	7.2425
Germany	.4239	2.3590
Italy	.0006221	1607.50
Japan	.005476	182.60
Mexico	.002151	465.00
Netherlands	.3753	2.6643
Switzerland	.5105	1.9590
U.K.	1.4180	.7052

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